RB 2009-02 Guidance on Other Real Estate Owned (OREO)

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Introduction

Continued weakness in the housing market and the rise in foreclosure have increased the potential for credit unions to acquire other real estate. This bulletin is being issued to remind credit unions the need to establish policies and procedures for acquiring, holding, and disposing of OREO. These policies and procedures should ensure that the credit union's interests in the other real estate are protected while mitigating the impact on the value of surrounding properties; and follow safe and sound practices.

Background

Real estate acquired by foreclosure is generally an undesirable asset, and may be subject to additional losses, even when recorded at fair value. When the credit union's interest in OREO is compared with a performing loan, it becomes evident that OREO is a substandard investment. A loan generally is protected by the borrower's paying capacity and equity in the property. A performing loan earns interest, and all the expenses of holding the property are borne by the owner/borrower. Conversely, OREO is a non-earning asset with no cushion between the credit union's recorded investment and the fair value of the property. The credit union must expend

time and resources to acquire, repair, and sell the property. Furthermore, the acquisition of the property indicates a lack of demand (at least at the current "asking price").

As used in this Bulletin, a credit union may hold OREO only if acquired by:

- Purchase under judicial or nonjudicial foreclosure, or through a deed in lieu of foreclosure, of real estate that is security for a debt or debts previously contracted in good faith;
- Purchase to protect its interest in a debt or debts previously contracted if prudent and necessary to avoid or minimize loss;
- Relocation of credit union premises; and
- Abandonment of plans to use real estate acquired for future expansion for credit union premises.

Initial Booking of OREO

7 TAC Section 91.515 requires OREO to be accounted for in accordance with generally accepted accounting principles (GAAP). Each parcel of OREO should be booked at the lower of its current book value (loan balance) or its fair value minus the estimated cost to sell the property on the date of transfer to the OREO category. The amount, if any, by which the recorded amount of the loan exceeds the fair value (less costs to sell) of the asset is a loss which must be charged to the allowance for loan and lease losses at the time of foreclosure.

Determining Fair Value

Upon transfer to OREO, fair value must be substantiated by a current appraisal prepared by an independent, qualified appraiser. All instructions from the credit union to the

appraiser should be in writing. The appraiser should estimate the cash price that might be received upon exposure to the open market for a reasonable time, considering the property type and local market conditions. When a current sale is unlikely, i.e., when it is unlikely that the sale can be completed within 12 months, the appraiser must discount all cash flows generated by the property to obtain the estimate of fair value. Cash flows include, but are not limited to, those arising from ownership, development, operation, and sale of property. The discount applied should reflect the appraiser's judgment of what a prudent/knowledgeable purchaser, under no necessity to buy, would be willing to pay for the property in a current sale. Whenever the appraiser believes that more than one year is necessary for a fair sale of the property, the appraiser should state and justify the estimated time and should state the annual discount rate applied. To substantiate the carrying value and to insure that the property has not declined in value, a new appraisal or a certification in letter form from an independent appraiser should be obtained annually.

Hold or Sell Decision

Once a credit union acquires an OREO property, the board should begin the decision-making process of whether to hold the property or sell it. A primary consideration when selling the asset is whether the credit union will have to make a loan to facilitate the sale. The credit union must consider the overall cost if it regains the property by later having to foreclose on the loan to facilitate. If a subsequent foreclosure becomes necessary, the condition of the property may be worse than when the credit union initially took possession. Moreover, if the most recent borrower fails to service the debt at all, the credit union has sacrificed any income it could have received from an interim use of the property.

In making the decision when and if to sell the OREO at the least cost to the credit union, the board should attempt to quantify, at a minimum, the following costs and benefits:

- Loss on an encumbered quick sale of property "as is."
- Cost of completing, restoring, and enhancing the project.
- Cost to prevent deterioration of the asset during the anticipated holding period:
 - Insurance
 - Physical security (fencing, security service, etc.)
 - Maintenance (mowing, utilities, structural repair, etc.)
 - Intangible (lost goodwill, etc.)
- Cost of selling the property (advertising, broker's commission, defects observed at inspection, etc.).
- Opportunity costs to the credit union, for example, based on the alternative uses of the sales proceeds.
- Cost of providing favorable financing.
- Anticipated appreciation or depreciation during the holding period.
- Benefit when the property is sold at the end of the holding period.

OREO Workouts

A credit union's board should assess the level of in-house expertise available to manage OREO workouts. A credit union should consider the possibility of looking outside the institution for the necessary level of expertise. This should include recruiting and employing real estate workout specialists and using real estate workout companies on a contract basis.

The board is responsible for reviewing the economic merits of out-sourcing OREO disposition plans. If any credit union identifies any regulatory issues of concern during its process

of selecting an outside OREO workout program, it should raise these issues with the Department. Credit unions should be aware that the Department neither approves nor endorses specific OREO workout proposals.

Subsequent Costs

Ongoing expenses not associated with acquiring clear title to the property (i.e., taxes, hazard insurance, utilities, etc.) should be expensed as incurred. Costs incurred to protect the credit union's investment in OREO which is improved or under construction, and which are to place a property in a saleable condition may be capitalized in accordance with GAAP. Additional investments which alter the current status or intended use of the property or made for the purpose of speculating in real estate are not allowed.

Subsequent Valuations

If any subsequent valuation indicates a reduction in the value of a property below the current book value, the credit union should recognize the deficiency as a valuation allowance against the asset, which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) through charges or credit to expense for changes in the asset's value or estimated selling costs. In no event, however, should the carrying value of the property be increased to an amount greater than the original book value at the time of acquisition or transfer to the other real estate category. For reporting purposes, the reserve account should be netted against the book value of the OREO and is not considered as part of the credit union's net worth structure.

Maintenance of a general reserve for losses on the sale of OREO and write-downs below the appraised value are not consistent with GAAP. Write-downs below the appraised value should be supported by reasonable documentation.

Documentation Requirements

Credit unions are expected to maintain documentation showing compliance with GAAP and good faith efforts to dispose of each parcel of OREO. Minimum documentation includes:

- A current appraisal prepared by an independent, qualified appraiser;
- Specific action plans for disposal of each parcel of OREO. The review of such action plans should be recorded in the official records of the board;
- A record of inquiries and offers by potential buyers;
- Decisions made and actions taken by the board on all verbal or written offers received;
- Methods used in advertising the property for sale whether by the credit union or its agent; and
- Other information reflecting sales efforts

Holding Period

A credit union should dispose of OREO as soon as prudent business judgment dictates. Generally, however, the holding period should be no longer than two years from the date it is originally acquired or transferred to that asset category. If at any time before the end of the holding period the credit union can recover the amount of its original loan plus additional advances and other costs related to the loan or the parcel of OREO, it should promptly dispose of the parcel. If the OREO is not sold within the initial holding period, the credit union should contact the Department and provide justifying information, data and reports to substantiate the need to extend the holding period. A longer holding period may necessitate the funding of additional special reserves for the OREO property.

Credit Union Financing of OREO Purchases

If the sale of foreclosed property will be financed by the credit union at less than current market interest rates, GAAP requires that the loan be discounted to bring its yield to a market rate. The effect of the discount will be either to increase the loss or to reduce the gain that results from the sales transaction. Interest income is then recognized at a constant yield over the life of the loan.

In cases where the credit union facilitates the sale of foreclosed property by requiring little or no down payment, GAAP requires that the profit on sales of the foreclosed property be deferred until an adequate down payment (depending on the type of property, up to 25 percent of the discounted sales price) has been received. However, losses should be recorded immediately.

Conclusion

OREO is frequently an unsound asset, even when carried at or below the appraised value. The credit union's purchase of the property through foreclosure usually indicates a lack of demand. As time lapses, the lack of demand becomes more firm, and the soundness of real estate for which there is no demand becomes more questionable. Credit unions usually lose money in liquidating other real estate owned despite the apparent adequacy of the appraised value.

Examiners will review all relevant factors to determine the quality and risk of the parcel of OREO and the degree of probability that its carrying value will be realized. In conducting the analysis, some of the factors the examiner will consider include:

- The property's carrying value relative to its appraised value, the credit union's asking price, and offers received.
- The length of time the property has been on the market

and local market conditions for the type of property involved, e.g., history of and trend of recent sales for comparable properties.

- The credit union's ability and track record in liquidating assets acquired in satisfaction of debts previously contracted.
- Income generated by the property and other economic factors affecting the probability of loss exposure.
- The manner in which the credit union intends to dispose of the property.
- The source and quality of the appraisal.
- Other pertinent factors, including the title, zoning, other liens, tax status, and